DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0390
Sales/Use Tax
For Tax Periods: 1995 through 1997

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ISSUES

I. Sales/Use Tax—Packaging and Shipping Supplies

Authority: IC 6-2.5-5-3; IC 6-2.5-5-3; IC 6-2.5-4; IC 6-2.5-5-5.1;
45 IAC 2.2-5-16; 45 IAC 2.2-5-8;
General Motors v. Dept. of State Revenue, 578 N.E.2d 399 (Ind.Tax 1991)

Taxpayer protests proposed assessments of use tax on purchases of packaging and shipping supplies.

II. Sales/Use Tax—Utilities

Authority: IC 6-2.5-44(c)(3); IC 6-2.5-4-5;
45 IAC 2.2-4-13; 45 IAC 2.2-5-12(b);

Taxpayer protests proposed assessments of use tax on a fraction of its utility purchases.

III. Sales/Use Tax—Gloves

Authority: IC 5-2.5-3(b);
45 IAC 2.2-5-8(c)(2)

Taxpayer protests proposed assessments of use tax on its purchase of gloves.

STATEMENT OF FACTS

Taxpayer, an industrial processor, applies plastic coatings to tangible personal property owned by its customers. During the audit period (1995 through 1997), taxpayer purchased a variety of supplies and utilities. At issue are Audit's proposed assessments of use tax on several of these purchases.

I. Sales Tax—Packaging and Shipping Supplies

DISCUSSION

Taxpayer's customers manufacture tangible personal property. At some point in their respective production processes, the manufacturers send product to taxpayer for application of plastic coatings. Once taxpayer has completed its work, these "coated" products are returned to the manufacturers. To facilitate this transfer of product, taxpayer purchased a variety of packaging and shipping items.

Audit based its proposed assessments on 45 IAC 2.2-5-16. The relevant portion of 45 IAC 2.2-5-16 reads:

> (a) The state gross retail tax [i.e., sales tax] shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added....
>
> * * * * *
>
> (d) Application of the general rule.
>
> (1) Non returnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:
>
> (A) The purchaser must add contents to the containers purchased; and
>
> (B) The purchaser must sell the contents added.

Taxpayer (according to Audit) is engaged as an industrial processor. As such, taxpayer "does not own the products that are coated and placed in the [purchased] containers...[therefore] taxpayer fails the second requirement [B] that it must sell the contents added."

Taxpayer also has purchased a variety of pallets. Half are used to move work-in-process while the other half are used for shipping "coated" products back to the manufacturers. Audit did not propose assessments on pallets used to move work-in-process within taxpayer's facility. Proposed assessments were made, however, on the pallets used in taxpayer's post-production shipping activities. (see IC 6-2.5-5-3 and 45 IAC 2.2-5-8.)

Taxpayer contends Audit's analysis and conclusions are incorrect. Taxpayer argues that its shipping and packaging materials, as well as its pallets, should be exempt from Indiana sales and use taxes because they are essential an integral to an integrated production process. Taxpayer compares its situation to that of General Motors. Taxpayer explains:

> In *General Motors v. Dept. of State Revenue* [578 N.E.2d 399 (Ind.Tax 1991)], both parties agreed that an integrated production process ends when a finished marketable product is produced, and the court ruled that an integrated process ends when the most marketable finished product is produced. The taxpayer [in this instance] is part of its

> customer's integrated production processes since the taxpayer produced no finished marketable products. The court [in *General Motors*] further stated that unless the parts are carefully transported from component plant to assembly plant no marketable automobiles could result. This is also true in the business of the taxpayer. If the coated products are shipped back to the customer without protection the parts would be scratched, broken or otherwise damaged, consequently, unusable by the customers in its finished product. Therefore, the boxes and pallets used in the taxpayer's packaging and shipping are an essential and required part of the integrated process of the taxpayer.

Taxpayer's *Protest Letter*, June 22, 1998, pp 3,4.

The Tax Court of Indiana ("court"), in *General Motors*, was asked to determine whether General Motors' (GM's) purchases of expendable packing materials—materials used to package and protect products during transport from component to assembly plants—were used within an integrated production process. The court, in holding for GM, explained:

> GM's component parts are unfinished work in process when actually used in GM's finished most marketable product, fully assembled automobiles. The end of an integrated production process is not signaled by the production of unfinished work in process merely because it is potentially a finished marketable product. **An integrated production process terminates upon the production of the most marketable finished product, e.g., the product actually marketed.** Consequently, GM's manufacture of finished marketable automobiles is accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants is an essential and integral part. (emphasis added.)

Id. at 404.

General Motors stands for the general proposition that an integrated production process terminates only when the most marketable product has been produced. Application of this general rule requires, by its very terms, identification of a "most marketable product." In *General Motors*, the item denominated as "most marketable product" was a fully assembled automobile rather than manufactured component parts. This determination resulted in a "redefinition" of taxpayer's integrated production process (by the Department) to the extent that GM's geographically dispersed multi-facility processes were now considered part of GM's continuous integrated production process. Consequently, the packaging purchased to facilitate the transfer of parts from taxpayer's component plants to assembly plants were found to be essential and integral to the transfer of works in process.

In finding GM's integrated production process encompassed manufacturing activities performed at multiple sites, the court identified several significant factors. Specifically, the court observed:

> The facts in the case [FN3] as well as previous judicial findings [FN4] indicate GM's production process is by nature ***highly integrated***. The court's sole concern, however, is whether GM's manufacture of finished automobiles qualifies ***as one continuous integrated production process.*** (emphasis added.)

Id. at 402.

The aforementioned footnote 3 (FN3) brings to light evidence the court relied on in reaching its conclusion that GM's production process was both "continuous" and "integrated;" to wit, "GM's component plant personnel collaborate with the assembly plant personnel" in a variety of functional manufacturing areas. Additionally, the court noted that "a continuity of production exists between GM's different plants [which is] demonstrated by the standard practice of shifting certain production operations back and forth between component and assembly plants when necessary...."

In footnote 4 (FN4), the court cited a variety of cases for the proposition that labor unrest at one plant affects operations at all plants. "The strike had the expected effect of disrupting the company's automotive operations at all locations, which are admittedly ***highly integrated and interdependent***." (emphasis added.) *Aaron v. Review Board of the Indiana Employment Security Division*, 416 N.E.2d 125, 129 (Ind.App 1981).

In the context of these facts and findings, the court found that GM's manufacture of automobiles represented, in toto, one "continuous integrated production process." *General Motors* at 404. Consequently, the court deemed GM's assembled automobiles, and not the component parts, to be the most marketable product.

As the court's analysis illustrates, determination of a "most marketable product" cannot be divorced from an evaluation of the processes involved in the creation of the product. As we learned from *General Motors*, to qualify for any of the industrial exemptions, the processes used must not only be "essential" and "integral" with regard to the production of the marketed product, but must be performed within a continuous integrated production process.

The popularity of the "most marketable product" analysis proceeds unabated. Such analysis has been embraced in increasing numbers—especially by those taxpayers engaged in decentralized, vertically integrated businesses. These entities, for exemption purposes, have attempted to construct a singular continuous integrated production process via annexation of smaller, disparate production processes.

Pursuant to the "industrial exemptions" provided by IC 6-2.5-5-3 through IC 6-2.5-5-5.1, the boundaries of any particular entity's production process or processes cannot extend beyond the boundaries of the entity itself. Such limitation effectively prohibits inclusion of a subsidiary's production processes with that of its sister or parent. Additionally, this limitation serves to prohibit taxpayer (as an industrial processor) from annexing its customers' (i.e., the manufacturers') processes for purposes of claiming the industrial exemptions.

The court in *General Motors* relied on facts as well as previous judicial findings in reaching its conclusion that GM's manufacturing process was both "continuous" and "highly integrated." Consequently, absent evidence of the existence of a "continuous and highly integrated process", an identification of the "most marketable product," without more, is insufficient for purposes of claiming any of Indiana's industrial exemptions.

FINDING

Taxpayer's protest is denied.

II. Sales Tax—Utilities

DISCUSSION

Taxpayer, an industrial processor, consumes varying amounts of water, electricity, and natural gas (collectively referred to as "utilities"). Each utility is predominately used by taxpayer in its processes. Taxpayer, invoking IC 6-2.5-4-5(c)(3), believes it is entitled to the one hundred percent (100%) "predominant use" exclusion for these utility purchases. Taxpayer reasons it is entitled to this statutory exclusion "[b]ecause...taxpayer's process is part of an integrated process that manufactures a finished marketable [product]. Audit, however, has approved taxpayer's utility exemptions on a pro rata basis.

"[T]he furnishing of electricity, gas, water...services by public utilities to consumers is subject to the gross retail tax. 45 IAC 2.2-4-13. But an exemption is provided for those sales of tangible personal property (including water, electricity, and natural gas) "directly consumed in direct production by manufacturing, processing, refining, or mining." 45 IAC 2.2-5-12(b). Additionally, a one hundred percent exclusion applies when the utility purchases have not been separately metered (as in this case) and the services have been "predominately used" by the purchaser for excepted purposes. As IC 6-2.5-4-5(c)(3) instructs:

> [T]his exclusion for sales of services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses listed in this subdivision, or if those sales are not separately metered but are predominately used by the purchaser for the excepted uses listed....

The excepted "uses" mentioned are afforded to only those utility purchasers engaged in "manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture." *Id.*

Taxpayer believes that as a provider of processes essential and integral to the manufacture of tangible personal property, taxpayer should be entitled to this "predominate use" exclusion. As taxpayer explains:

> Because the taxpayer's process is part of an integrated process that manufactures a finished marketable tangible personal property, 100% of the taxpayer's utility purchases are exempt from the Indiana Retail Sales Tax.

In other words, taxpayer wishes to be included in its customer's production processes in order to qualify for the predominant use utility exclusion. The Department has already responded to similar arguments with regard to taxpayer's industrial exemption claims. As previously stated:

> [The boundaries of any particular entity's production process or processes cannot extend beyond the boundaries of the entity itself. Such limitation effectively prohibits inclusion of a subsidiary's production processes with that of its…[sibling] or parent. Additionally, this limitation serves to prohibit taxpayer (as an industrial processor) from annexing its customers' (i.e., the manufacturers') processes for purposes of claiming the industrial exemptions.

Such logic applies equally to taxpayer's "predominant use" utility claims.

Taxpayer may not annex its customers' production processes for purposes of claiming statutory exclusions and exemptions. Unfortunately for taxpayer, not even the most expansive definition of "integrated production process" anticipates or suggests that the boundaries of such processes should exceed those of the entities claiming them.

FINDING

Taxpayer's protest is denied.

III. Sales Tax—Gloves

DISCUSSION

Audit proposed assessments of use tax on taxpayer's acquisition of gloves worn by its employees. As Audit explains, "taxpayer acquired...gloves (thin knit offering no protection to employees) exempt from tax." (Presumably, Audit was responding to taxpayer's argument that the gloves were required so taxpayer's employees could perform their work.)

"Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture...processing, refining, or finishing of other tangible personal property. IC 5-2.5-3(b). Items that are "essential and integral" to an integrated production process meet this "double direct" standard. As 45 IAC 2.2-5-8(c)(2) notes:

> The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt....
>
> (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

45 IAC 3.3-5-8(c)(2).

Taxpayer contends the gloves serve as a barrier to prevent the possibility of product contamination. Taxpayer's explanation of the utility of its gloves for the prevention product contamination is plausible and convincing.

FINDING

Taxpayer's protest is sustained.

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